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No. 97-1732

IN THE

Supreme Court of the United States

OCTOBER TERM, 1998

CALIFORNIA PUBLIC EMPLOYEES RETIREMENT SYSTEM AND FLORIDA STATE BOARD OF ADMINISTRATION,

Petitioners,

v.

PAUL FELZEN, ET AL.,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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BRIEF OF PROFESSORS LAWRENCE A. HAMERMESH AND MARY BRIGID McMANAMON AS *AMICI CURIAE* SUPPORTING PETITIONERS

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BRIEF OF PROFESSORS LAWRENCE A. HAMERMESH AND MARY BRIGID McMANAMON AS *AMICI CURIAE* SUPPORTING PETITIONERS

The undersigned respectfully submit this brief as *amici curiae* supporting the petitioners, California Public Employees' Retirement System and Florida State Board of Administration.[1]

INTEREST OF THE *AMICI*

Professor Lawrence A. Hamermesh is Associate Professor of Law, Widener University School of Law, Wilmington, Delaware. A member of the Delaware Bar since 1976, Professor Hamermesh practiced law in Wilmington, Delaware, until 1994, principally in the field of corporate litigation, including stockholder derivative and class action litigation. Professor Hamermesh teaches courses in business organizations, securities regulation, corporate finance, and mergers and acquisitions. Professor Hamermesh's interest in submitting this *amicus* brief is in ensuring that the Court is duly apprised of the substantive law and practice of Delaware in relation to stockholder derivative actions.

Professor Mary Brigid McManamon is Associate Professor of Law, Widener University School of Law,

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[1] No counsel for a party authored any part of this brief. The Council of Institutional Investors, which is an association of institutional investors, is making a monetary contribution to the preparation and submission of this brief. The parties consented to the filing of this brief, as reflected in letters on file with the Court.

Wilmington, Delaware. She has been teaching in the field of federal procedure, including courses in Civil Procedure, Federal Courts, Complex Litigation, and Conflict of Laws, since 1985. In addition, she has published law review articles on the history of federal procedure and has been a co-author of one of the major casebooks on Civil Procedure since 1997. Professor McManamon's interest in submitting this *amicus* brief is in ensuring that the Court is duly apprised of the historical practice under Federal Rule of Civil Procedure 23.1, with particular emphasis on the federalism concerns raised by the Seventh Circuit's creation of new federal common law.

SUMMARY OF ARGUMENT

1. In a stockholder derivative action, the law of the state of incorporation of the entity on behalf of which claims are being asserted should determine the entitlement of a stockholder to appeal approval of a settlement of the action, just as the law of the state of incorporation determines the entitlement of a stockholder to initiate and conduct the action.

2. In declining to permit a stockholder to appeal approval of a settlement without formally intervening as a party, the court below underestimated the stockholder's interest in such a settlement as a matter of applicable state substantive law, here Delaware law.

3. Consistent with the interest of stockholders as a matter of substantive law in the settlement of a derivative action on behalf of a Delaware corporation,

the Delaware courts have consistently allowed objectors to a settlement of such an action to appeal approval of a settlement without having formally intervened as a party. This Court should direct that this approach be followed in this case.

ARGUMENT

I. IN DERIVATIVE ACTIONS ASSERTING CLAIMS ARISING UNDER STATE LAW, STATE LAW RULES REGARDING THE CONDUCT OF DERIVATIVE ACTIONS AND THE PROSECUTION OF APPEALS IN SUCH ACTIONS SHOULD GOVERN DERIVATIVE ACTIONS IN THE FEDERAL COURTS.

In 1938, this Court both promulgated Federal Rule of Civil Procedure 23(b), now Rule 23.1, and limited its scope by holding in *Erie Railroad v. Tompkins*, 304 U.S. 64, 78 (1938), that, "[e]xcept in matters governed by the Federal Constitution or by acts of Congress, the law to be applied in any case is the law of the state." The impact of this holding on former Rule 23(b) was recognized immediately. At the Proceedings of the Institute on Federal Rules held July 21, 1938, William D. Mitchell, chair of the Supreme Court Advisory Committee, noted:

> Many years ago, in *Hawes v. Oakland*, 104 U.S. 450, 26 L. ed. 827 (1881), the Supreme Court held, as an equitable principle, that a shareholder could not maintain [a derivative action on behalf of the corporation] if he did not own

the shares when the act complained of was committed.

. . . .

Now, if the question of the right to maintain suit, depending on whether the plaintiff owned the shares when the act was complained of or not, is a matter of substantive right, then it is possible under *Erie Railroad v. Tompkins*, which now makes the decision of the state court binding on federal courts in the matter of substantive law, that the court may say that this question of the right of a shareholder to sue and the condition on which his right is predicated, is a matter of state law, and the federal courts no longer may have a rule of their own, but must follow the local state decisions on that point.

Proceedings of the American Bar Association Institute on Federal Rules at Cleveland, Ohio 184 (W. Dawson ed. 1938).

Mr. Mitchell's concern proved well-founded, as the federal courts immediately had to grapple with the question of whether Rule 23(b) impermissibly affected substantive rights. As early as 1941, the Third Circuit held that a shareholder's ability to participate in the litigation of a derivative suit is a substantive issue, which must be determined in a diversity action by the law of the state of incorporation. *Gallup v. Caldwell*, 120 F.2d 90, 93 (3d Cir. 1941). After some early confusion on this

issue among the circuits,[2] this Court directed that Rule 23(b), and later Rule 23.1, should be interpreted so as not to affect substantive rights,[3] and the *Gallup* court's

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[2] In 1944, the Advisory Committee on Rules for Civil Procedure considered amending Rule 23(b), noting:

> As a result of the decision in Erie R. Co. v. Tompkins, 304 U.S. 64, 58 S.Ct. 817 (82 L.Ed. 1188, 114 A.L.R. 1487) (decided April 25, 1938, after this rule was promulgated by the Supreme Court, though before it took effect) a question has arisen as to whether the provision above quoted deals with a matter of substantive right or is a matter of procedure.

1947 Special Pamphlet to 28 U.S.C. §§ 721-723, at 19, *quoted in HFG Co. v. Pioneer Publ'g Co.*, 162 F.2d 536, 539 (7th Cir. 1947). The committee decided to do nothing at that time, however, concluding that "[t]here is reason to say that the question is one which should not be decided by the Supreme Court ex parte, but left to await a judicial decision in a litigated case." *Id.* at 22, *quoted in HFG Co.*, 162 F.2d at 539.

[3] *See, e.g.*, *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90 (1991); *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 535 (1949); *see also Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R.*, 417 U.S. 703, 713-14 (1974) (applying law of state of incorporation to question of standing in state law claims). In *Kamen*, this Court went so far as to hold that

position is now the generally accepted rule.[4] This rule, that the applicable substantive law governs a shareholder's right to participate in the litigation of a derivative suit, applies not only to the plaintiff, but also to a shareholder objecting to a proposed settlement. *See In re Pittsburgh & Lake Erie R.R. Sec. & Antitrust Litig.*, 543 F.2d 1058, 1065-67 (3d Cir. 1976) (holding standing to object to settlement of federal claim is federal law question). Given the very real problem of collusion in the settlement of shareholder derivative suits (*see* Br. of Amicus Curiae Council of Inst'l Investors Part I, A), the underlying substantive law recognizes that the objecting shareholder is every bit as important to the vindication of the corporation's rights as the named plaintiff. *See* discussion *infra* Part II.

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in a derivative action arising under *federal* law, the need for uniformity in corporate governance overcame any need for uniformity of federal practice, and thus a shareholder's standing should be determined by the law of the corporation's state of incorporation, unless that law frustrated federal objectives. 500 U.S. at 97-98.

[4] *E.g.*, *RCM Sec. Fund, Inc. v. Stanton*, 928 F.2d 1318, 1329-30 (2d Cir. 1991); *Wolgin v. Simon*, 722 F.2d 389, 391-92 (8th Cir. 1983); *Burghart v. Landau*, 821 F. Supp. 173, 176-78 (S.D.N.Y. 1993); *Norton v. National Research Found.*, 141 F.R.D. 510, 512 (D. Kan. 1992); *In re Storage Tech. Corp. Sec. Litig.*, 804 F. Supp. 1368, 1375 (D. Colo. 1992); *see Lewis v. Chiles*, 719 F.2d 1044, 1047-48 (9th Cir. 1983); *see also* 7C Charles Alan Wright *et al.*, *Federal Practice and Procedure* § 1826 (2d ed. 1986).

The objecting shareholder's role does not end with the approval of a settlement. The governing substantive law recognizes the importance of the objector's right to appeal such approval to assure vindication of the corporation's rights. *See* discussion *infra* Part III. It is entirely appropriate for the circuit courts, hearing appeals in diversity cases, to be sensitive to that important state interest. This Court has recently reminded us that that the principles of *Erie* govern the appellate courts, as well as the trial courts. *See Gasperini v. Center for Humanities, Inc*, 518 U.S. 415 (1996); *Salve Regina College v. Russell*, 499 U.S. 225 (1991). And the federal courts have recognized and been sensitive to the importance of the objecting shareholder in the derivative suit. In 1942, the Sixth Circuit expressly allowed such a shareholder to appeal the approval of a settlement without the need to intervene below. *Cohen v. Young*, 127 F.2d 721, 724 (6th Cir. 1942). Thereafter, the circuits routinely allowed objectors in shareholder derivative suits to appeal without intervening.[5] The Seventh Circuit itself declared:

> The law is clear that a non-party shareholder who appears, pursuant to a

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[5] *See, e.g.*, *Jones v. Nuclear Pharmacy, Inc.*, 741 F.2d 322 (10th Cir. 1984); *Girsh v. Jepson*, 521 F.2d 153 (3d Cir. 1975); *Greenspun v. Bogan*, 492 F.2d 375 (1st Cir. 1974); *United Founders Life Ins. Co. v. Consumers Nat'l Life Ins. Co.*, 447 F.2d 647 (7th Cir. 1971); *Neuwirth v. Allen*, 338 F.2d 2 (2d Cir. 1964); *Masterson v. Pergament*, 203 F.2d 315 (6th Cir. 1953).

> Rule 23.1 notice, to present objections to a proposed dismissal or settlement of a derivative action may appeal an adverse decision even though he has not been formally made a party to the action.

Tryforos v. Spanos, 518 F.2d 1258, 1263 n.22; *see* 3B James W. Moore, *Federal Practice* ¶ 23.1.24[3] (2d ed. 1996).

With the exception of the Seventh Circuit's opinion in the case at bar, no circuit has reversed its position on an objecting shareholder's right to appeal. Quite the contrary. Every circuit that has discussed the question in recent years has reaffirmed the objector's right to appeal without intervention. *See Rosenbaum v. MacAllister*, 32 F.3d 1439, 1441-43 (10th Cir. 1995) (allowing objector to appeal without intervention, noting difference between Rule 23 case and Rule 23.1 case); *Shults v. Champion Int'l Corp.*, 35 F.3d 1056, 1059-60 (6th Cir. 1994) (expressly reaffirming its earlier opinion in *Cohen v. Young*); *Bell Atl. Corp. v. Bolger*, 2 F.3d 1304, 1307-10 (3d Cir. 1993) (expressly holding that objecting shareholder may appeal without intervening).

In contrast, the Seventh Circuit, overruling precedent and showing no sensitivity to the very real regulatory concerns of the underlying state law, held that an objecting shareholder must intervene in order to appeal the approval of a settlement in a Rule 23.1 derivative action. Moreover, the court rejected the thoughtful reasoning of its own precedent as well as that of the other circuits and ignored the role that an objector plays in a derivative suit. Instead, the court below held

that it could not entertain the objector's appeal because it was outside the court's jurisdiction. The court's reasoning, however, cannot withstand close scrutiny.

When determining if a matter is within the jurisdiction of a federal court, the first place to look is the jurisdictional statute. In this case, the controlling statute is 28 U.S.C. § 1291. That section provides: "The courts of appeals . . . shall have jurisdiction of appeals from all final decisions of the district courts of the United States, . . . except where a direct review may be had in the Supreme Court." The Seventh Circuit had before it a final decision of the U.S. District Court for the Central District of Illinois, and this case is not one in which there may be a direct review in this Court, *cf. id.* § 1253 (providing for direct review from decisions of three-judge courts). Thus, there is no statutory bar to the Seventh Circuit's hearing this appeal.

This statutory grant of jurisdiction must, of course, be tested by the bounds of Article III of the U.S. Constitution. In this regard, there are two issues that must be addressed. First, is this case within the judicial power of the United States? As Chief Justice John Marshall declared, with the exception of those cases within the original jurisdiction of this Court, "the [judicial] power [of the United States] is to be exercised in its original or appellate form, or both, as the wisdom of Congress may direct." *Osborn v. Bank of the United States*, 22 U.S. (9 Wheat.) 738, 820 (1824). Thus, if this case is within the bounds of Article III in its original form, it is also within the bounds of Article III in its appellate form. The district court had subject matter jurisdiction over this diversity case. Therefore, the Seventh Circuit

is also competent to hear this matter. Second, does this case present an Article III "case or controversy," i.e., do the appellants have standing? Objecting shareholders have consistently been found to have standing to appeal the approval of the compromise of a derivative action. *See* discussion *supra*. Even the Seventh Circuit did not deny that the objectors in the case at bar had standing. *See* 134 F.3d at 876. Thus, there is no constitutional bar to the Seventh Circuit's hearing this appeal.

So, on what authority did the Seventh Circuit conclude that it lacked jurisdiction to hear this appeal? First, the court cited *Marino v. Ortiz*, 484 U.S. 301, 304 (1988). That case, however, is completely inapposite to the one at bar. In *Marino*, non-class members objected to the settlement of a class action without intervening. Not surprisingly, this Court affirmed the lower court's dismissal of their appeal. They had no relationship to the parties or the lawsuit and would not have been barred by *res judicata*. In the present case, objecting shareholders, who are in privity with the parties, *Nathan v. Rowan*, 651 F.2d 1223, 1226 (6th Cir. 1981),[6] have appealed the compromise of a derivative suit. Not only will *res judicata* apply to them, *id.*, but, because they appeared in court in answer to the court's notice to show cause why a settlement should not be approved, they are considered to be "'like a defendant who is summoned by process of court and after an adverse

[6] "[I]n shareholder derivative actions arising under Fed.R.Civ.P. 23.1, parties and their privies include the corporation and all nonparty shareholders." *Id.*

ruling has the right to appeal.'" *Cohen v. Young, supra*, 127 F.2d at 724.[7] There are too many legally important differences between *Marino* and the present case for the former to control the latter.

As further evidence that *Marino* is inapplicable to this case, one need only look at the case relied on by this Court as authority for its ruling: *United States ex rel. Louisiana v. Jack*, 244 U.S. 397, 402 (1917). The *Jack* Court was faced with an appeal of a settlement involving certain real estate by the State of Louisiana after the Supreme Court of Louisiana had held that the state had no interest in the lands in controversy. In other words, the nonintervening objector could not appeal the approval of the settlement because the *governing state law denied it the right to object*. That is the converse of the present case, in which the governing state law specifically gives the objectors the right to appeal, *see* discussion *infra* Part III, and thus cannot control the decision here.

Second, the Seventh Circuit relied on Federal Rule of Appellate Procedure 3(c), which merely provides that, "[a] notice of appeal must specify the party or parties taking the appeal by naming each appellant in either the caption or the body of the notice of appeal." This language is very odd to choose as evidence of a jurisdictional bar, especially in light of this Court's

[7] The Sixth Circuit quoted *Pianta v. H.M. Reich Co.*, 77 F.2d 888, 890 (2d Cir. 1935), which applied the same principle to nonintervening nonparty creditors who wished to challenge the acts of receivers.

conclusion that requiring a nonparty to seek intervention before appealing is simply "the better practice." *Marino*, 484 U.S. at 304. More importantly, however, Rule 3(c), formerly Federal Rule of Civil Procedure 73(b), was promulgated pursuant to the Rules Enabling Act, 28 U.S.C. § 2072, which provides that "[s]uch rule[ ] shall not abridge, enlarge or modify any substantive right." An objecting shareholder in a derivative suit plays an important role, both at the trial and appellate levels, in the vindication of the substantive rights of the corporation. *See* discussion *infra* Parts II, III. Interpreting Rule 3(c) as the Seventh Circuit did eviscerates that role. This Court, when faced with such a choice, has wisely chosen to interpret the Federal Rule narrowly, thus avoiding a conflict with the substantive law. Only two years ago, this Court noted, "Federal courts have interpreted the Federal Rules . . . with sensitivity to important state interests and regulatory policies." *Gasperini, supra*, 518 U.S. at 427 n.7 .[8]

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[8] In *Gasperini*, this Court cited *Walker v. Armco Steel Corp.*, 446 U.S. 740, 750-52 (1980) (reaffirming decision in *Ragan v. Merchants Transfer & Warehouse Co.*, 337 U.S. 530 (1949), that state law rather than Federal Rule of Civil Procedure 3 determines when a diversity action commences for the purposes of tolling the state statute of limitations; Rule 3 makes no reference to the tolling of state limitations, the Court observed, and accordingly found no "direct conflict"); *S.A. Healy Co. v. Milwaukee Metropolitan Sewerage Dist.*, 60 F.3d 305, 310-12 (7th Cir. 1995) (finding state provision for offers of settlement by plaintiffs compatible with Federal Rule of Civil Procedure 68, which is limited to offers by defendants). *See also Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 535 (1949) (finding state provision for security for expenses did not conflict with then Rule 23(b), which was silent on the question).

In the present case, it is easy to find an interpretation of Rule 3(c) that does not conflict with the governing substantive law. Delaware law treats objecting shareholders in a Rule 23.1 action to all intents and purposes as parties, *see* discussion *infra* Part III, and, with the sole exception of the Seventh Circuit's opinion in the case at bar, the lower federal courts have done the same, *see* discussion *supra*. Thus, the phrase "party or parties" in Rule 3(c) should be simply interpreted to refer not only to those who are technically parties, but also to those who, like objecting shareholders in a derivative action,[9] are treated as parties by the underlying substantive law.

Moreover, unlike the situations facing this Court in *Byrd v. Blue Ridge Rural Electric Cooperative, Inc.*, 356 U.S. 525 (1958), and *Gasperini*, there is no strong countervailing federal interest here in adopting the Seventh Circuit's new, narrow interpretation of Rule 3(c). When the Rule was originally promulgated in 1938 as Federal Rule of Civil Procedure 73(b), the Advisory Committee's only concern was to abolish the practice of filing assignments of error in the district courts. *See*

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[9] Another example of such a *de facto* party might be a nonintervening nonparty creditor challenging the actions of a receiver. *See supra* note 7.

Fed. R. Civ. P. 73 advisory committee's note. When this Rule was re-promulgated in 1967 as Federal Rule of Appellate Procedure 3(c), the Advisory Committee, noting that the Rule was "identical with corresponding provisions in FRCP 73(b)," stressed only the importance of timeliness in the filing of a notice of appeal. *See* Fed. R. App. P. 3 advisory committee's note. Additionally, this Court has held that

> [t]he purpose of the specificity requirement of Rule 3(c) is to provide notice both to the opposition and to the court of the identity of the *appellant or appellants*. The use of the phrase "et al.," which literally means "and others," utterly fails to provide such notice to either intended recipient. Permitting such vague designation would leave the appellee and the court unable to determine with certitude whether a losing party not named in the notice of appeal should be bound by an adverse judgment or held liable for costs or sanctions.

Torres v. Oakland Scavenger Co., 487 U.S. 312, 318 (1988) (emphasis added). None of these policies would be frustrated, or even slightly affected, by interpreting the phrase "party or parties" to include those treated as parties by the governing substantive law.

Finally, to adopt the Seventh Circuit's unique approach would invite the kind of forum shopping this Court hoped to prevent by its decision in *Erie*. *See Hanna v. Plumer*, 380 U.S. 460, 468 (1965) ("twin aims of the *Erie* rule: discouragement of forum-shopping and

avoidance of inequitable administration of the laws"). In the case at bar, the substantive law provides the role of the objecting shareholder as a check on the very real threat of collusion between plaintiffs' attorneys and defendants in shareholder derivative suits. If Rule 3(c) is interpreted to place such burdens on playing that role that the check will be significantly eroded in federal court (*see* Br. for Barclays Global Investors, State of Wis. Inv. Bd., & Certain Other Inst'l Investors as Amici Curiae Supp'g Pet'rs Part I), given the choice, plaintiffs' attorneys will always choose federal court over state court, thus leading to the inequitable administration of the laws depending on the accident of diversity.

II. THE COURT BELOW UNDERESTIMATED THE SIGNIFICANCE OF THE OBJECTORS' INTEREST IN THE DERIVATIVE ACTION AS A MATTER OF SUBSTANTIVE LAW.

At least tacitly acknowledging the relevance of the position of the stockholder under applicable substantive law, the court below did examine the substantive position of stockholders of a Delaware corporation in relation to a stockholder derivative action. Several of its assertions in this regard, however, were inconsistent with Delaware substantive law. First, the court below asserted that stockholders "may not displace the board in litigation"; second, it asserted that "[s]hareholders have no more the attributes of parties when managers settle derivative litigation than when managers settle antitrust litigation"; and most bluntly and incorrectly, the court below asserted that "shareholders . . . have no more right to speak for the firm or control its litigation decisions than bondholders or banks or

landlords, all of whom have contractual interests that may be affected by litigation." 134 F.3d at 874-76.

This failure to distinguish stockholders from the various other constituencies affected by the disposition of a stockholder derivative action contravenes settled Delaware law defining the stockholder's interest in the control and disposition of the derivative action. Contrary to the assertion of the court below, the stockholders *do* "displace the board in litigation" where a derivative action is allowed to proceed: what they displace, more specifically, is the ordinary prerogative of the board of directors to determine, without stockholder approval or control, whether, when, and how to pursue litigation on behalf of the corporation.[10] Indeed, it is that very characteristic of derivative litigation that has resulted in strict limitations upon the ability of stockholders to initiate derivative actions, in which the ordinary managerial authority of the board of directors over the handling of corporate claims is displaced by stockholder action.[11] See, for example, *Heineman v. Datapoint*

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[10] *Spiegel v. Buntrock*, 571 A.2d 767, 772-73 (Del. 1990); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 782 (Del. 1981) ("Directors of Delaware corporations derive their managerial decision making power, which encompasses decisions whether to initiate, or refrain from entering, litigation, from 8 *Del. C.* §141(a).").

[11] *E.g.*, *Grimes v. Donald*, 673 A.2d 1207, 1215 (Del. 1996) (citing *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984)); *Rales v. Blasband*, 634 A.2d 927, 932 (Del. 1993); *Spiegel v. Buntrock*, 571 A.2d 767, 773 (Del.

Corp., 611 A.2d 950 (Del. 1992), which holds that even though the board of directors ordinarily "makes the ultimate decision of whether or not to prosecute the [corporation's] claim," stockholders may initiate and prosecute the claim derivatively where:

> a reasonable doubt exists that the board has the ability to exercise its managerial power, in relation to the decision to prosecute, within the strictures of its fiduciary obligations.

Id. at 952.

Thus, where the board of directors is considered capable of dealing with the corporation's claim "within the strictures of its fiduciary obligations," the stockholder derivative action must be dismissed for failure to make pre-suit demand. In contrast, where a stockholder derivative action is settled, and not dismissed for failure to make demand upon the board, it is at least implicit, if not explicit, that the plaintiff stockholder has the authority as a matter of substantive corporate law to pursue the action on behalf of the corporation without the approval of the board of directors.[12] In other words,

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1990) (citing *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 531 (1984)).

[12] In the instant case, the defendants sought to dismiss the action for failure to make a presuit demand upon the board of directors. The defendants chose to settle the action, however, rather than have the trial court determine their motion to dismiss. By doing so, the

and contrary to the assertion by the court below, the board of directors' power over the conduct of the litigation is displaced. No other constituency—neither the "bondholders or banks or landlords" mentioned in the opinion below—has this power "to speak for the firm [and] control its litigation decisions" that the state substantive law confers upon stockholders. 134 F.3d at 874.

It is true, as the court below observed, 134 F.3d at 875 (citing *Kamen, supra*), that the board of directors may, upon appropriate action, reclaim the power to control the conduct (or dismissal) of a derivative action.[13] Where such power has not been exercised, however, the stockholders are, as a matter of substantive corporate law, *not* strangers to the controversy; to the contrary, they continue to hold the power to conduct the litigation of the corporation's claims. *See, e.g.*, *Levine v. Smith*, 1987 Del. Ch. LEXIS 524, *16-*17 (Del. Ch. 1987), *aff'd*, 591 A.2d 194 (Del. 1991) (when a special litigation committee seeks

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defendants have secured a bar against prosecution of settled claims on behalf of the corporate defendant by anyone, anywhere, rather than simply a dismissal of the plaintiff in this action alone.

[13] *Grimes v. Donald*, 673 A.2d 1207, 1216 n.13 (Del. 1996); *Kaplan v. Wyatt*, 499 A.2d 1184 (Del. 1985); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 785-89 (Del. 1981) (establishing standards for judicial review of special litigation committee motion to terminate stockholder derivative action).

dismissal of the derivative action, "managerial power to control the destiny of the corporation's claim . . . is presumed to be properly vested in the stockholder-plaintiff," and the only issue is whether that power "should in essence be 'revested' in the Board of Directors.").

This substantive law position of stockholders in derivative actions is consistent with the the requirement of both Federal Rule of Civil Procedure 23.1 and Chancery Court Rule 23.1 that the stockholders be given notice of a settlement of a derivative action. That notice requirement reflects a recognition that the stockholders of the corporation have a unique and meaningful interest in the settlement of a derivative action, in contrast to the "employees, vendors, and lawyers" or other persons potentially affected by the settlement of a derivative suit, 134 F.3d at 874, none of whom are required by Rule to be given notice of the settlement. Thus, stockholders who objected to the settlement in this action, unlike members of other corporate constituencies, were invited by the trial court to appear at the settlement hearing to "show cause why the proposed Settlement should not be approved," including submission of "papers and briefs."[14]

Objectors to the settlement of a derivative action are distinguished from members of such other corporate constituencies in a number of additional ways not reflected in Federal Rule of Civil Procedure 23.1, that

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[14] Notice of Hr'g on Proposed Settlement of Derivative Actions, dated May 30, 1997, at 7.

confirm the substantive significance of the stockholders' interest. Notably, stockholders objecting to a proposed settlement of a stockholder derivative action are, unlike nonparties generally, usually afforded access to the discovery process, albeit on a limited basis consistent with the limited scope of the issues presented to the trial court in reviewing the proposed settlement.[15] Moreover, so significant is the interest of the stockholders in the derivative action that final judgments entered in settlement of such actions routinely make explicit that the judgment binds the stockholders individually and precludes them from asserting settled claims.[16] In contrast, we are aware of no judgments in stockholder derivative actions that attempt to operate explicitly and directly upon any other kind of person (employee, vendor, etc.) who may be affected by the judgment.

In sum, the court below failed to acknowledge the

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[15] *See, e.g., Lewis v. Hirsch*, 1995 Del. LEXIS 62, *3 (Del. Ch. 1995). *See generally* Donald J. Wolfe, Jr. & Michael A. Pittenger, *Corporate and Commercial Practice in the Delaware Court of Chancery* § 9-4(g) (1998).

[16] *See* 2 *Business and Commercial Litigation in Federal Courts* 66 (Robert L. Haig, ed. 1998) (model form of order and final judgment). The final judgment entered in this case likewise purports to operate directly on the individual stockholders of the corporation. *See* Petition for Certiorari herein, dated April 21, 1998, Appendix B, ¶7 (releasing claims "by any shareholder of [the] company derivatively on its behalf ... .").

significant role played by stockholders, including objectors to settlements, in the stockholder derivative action. Its assessment of the objectors' entitlement to appeal may thus have rested upon an underestimation of the objectors' substantive position under applicable Delaware law.

III. UNSUCCESSFUL OBJECTORS IN THE DELAWARE COURTS MAY APPEAL SETTLEMENT APPROVALS IN DERIVATIVE ACTIONS WITHOUT FORMAL INTERVENTION.

In Delaware, widely recognized as the predominant jurisdiction of incorporation of corporations the shares of which are publicly traded,[17] including the corporate defendant in this case, the courts have invariably and frequently allowed stockholders who have objected to the settlement of a derivative action, but who have not intervened as parties in the action, to appeal the approval of the settlement by the trial court, the Delaware Court of Chancery.

Nearly fifty years ago, the Delaware Supreme Court faced the very question now before this Court. *Braun v. Fleming-Hall Tobacco Co., Inc.*, 92 A.2d 302 (Del. 1952). The proponents of the settlement of a

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[17] According to the Division of Corporations of the Secretary of State of the State of Delaware, 60% of the Fortune 500 companies are incorporated in Delaware, and 50% of the corporations with shares listed on the New York Stock Exchange are incorporated in Delaware. <http://www.state.de.us/corp.index.html>.

stockholder derivative action sought to dismiss an objecting stockholder's appeal of the trial court's approval of the settlement on the ground, among others, that the objector "had not obtained an order granting him leave to intervene as a party." *Id.* at 307. The Delaware Supreme Court at first acknowledged that such intervention had been "the practice" of persons objecting to settlements. *Id.* at 308. Despite that recognition, however, the court found the nonintervening objector entitled to appeal approval of the settlement, reasoning:

> [The objector] was under a rule to appear before the Court of Chancery if he considered his interests in jeopardy; and it was pursuant to that rule that his counsel filed written objections to the settlement and made oral argument against the approval thereof. Nobody objected to either of these activities in the trial court. *What took place, therefore, amounted to actual intervention, even though it was without express leave of court.* If counsel for [the objector] had asked to intervene, an order granting leave would undoubtedly have been entered. *In these circumstances, therefore, we do not regard the failure to ask permission to intervene as any more than the oversight of a formality.*

Id. (emphasis added).

In the half century or so since *Braun* was decided, what the court described as "the oversight of a formality" has become common practice: objectors almost invariably assert their position without intervening formally, and the Delaware Supreme Court has never

once questioned the ruling in *Braun* that this approach does not preclude appeal by an unsuccessful objector.[18] To the contrary, that court has repeatedly entertained, on the merits, appeals by objectors to settlements of derivative actions, despite their not having intervened as parties. *Gladstone v. Bennett*, 153 A.2d 577 (Del. 1959); *Krinsky v. Helfand*, 156 A.2d 90 (Del. 1959); *Rome v. Archer*, 197 A.2d 49 (Del. 1964); *Hoffmann v. Dann*, 205 A.2d 343 (Del. 1964); *Goodman v. Futrovsky*, 213 A.2d 899 (Del. 1965); *Rutman v.Kaminsky*, 226 A.2d 122 (Del. 1967); *Neponsit Investment Co. v. Abramson*, 405 A.2d 97 (Del. 1979); *Geller v. Tabas*, 462 A.2d 1078 (Del. 1983) (noting that objectors who had brought separate suit in another State had made no attempt to intervene in the Delaware action, but ruling on the merits of objectors' appeal from approval of the settlement); *Polk v. Good*, 506 A.2d 531 (Del. 1986) (at time of approving the settlement, the Court of Chancery had denied objectors' motions to intervene, and appellate review addressed the merits of the objections without comment on the intervention ruling).

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[18] Similarly, stockholders routinely submit objections to proposed settlements in the Court of Chancery without seeking formal leave to intervene as a party. *E.g.*, *Cohan v. Loucks*, 1993 WL 121855 (Del. Ch. 1993); *Stepak v. Ross*, 1985 WL 21137 (Del. Ch. 1985); *Moses v. Pickens*, 1982 WL 17825 (Del. Ch. 1982); *Lewis v. Fuqua Industries, Inc.*, 1982 WL 8783 (Del. Ch. 1982); *Saminsky v. Abbott*, 194 A.2d 549 (Del. Ch. 1963); *Manacher v. Reynolds*, 165 A.2d 741 (Del. Ch. 1960).

This Delaware practice of allowing appeals by nonintervening objecting stockholders in derivative actions has continued unabated after this Court's decision in *Marino*. In *In re Resorts Int'l Shareholder Litigation Appeals*, 570 A.2d 259 (Del. 1990), one of several objectors to the settlement of a class and derivative action filed separate suit, shortly after filing of the settlement agreement, but none of the objectors sought to intervene in the action in which the settlement was submitted. The Delaware Supreme Court proceeded to rule on the merits of the appeal, notwithstanding that failure to intervene. Similarly, in *Kahn v. Sullivan*, 594 A.2d 48 (Del. 1991), California Public Employees Retirement System (CalPERS, one of the appellants in this case) had intervened in an action challenging conduct of Armand Hammer, the chief executive officer of Occidental Petroleum Corporation, a Delaware corporation, in relation to the funding of a museum to house Mr. Hammer's extensive art collection. In a separate derivative action (the Sullivan action) in the Delaware Court of Chancery addressing the same alleged misconduct, the parties agreed to a settlement and presented it for approval at a hearing on notice to the other Occidental stockholders, including CalPERS. *Without having intervened in the Sullivan action*, CalPERS submitted objections to the settlement, and appealed the approval of the settlement to the Delaware Supreme Court. That court entertained the appeal without any suggestion that CalPERS should have intervened in the action in which the settlement was

approved.[19]

CONCLUSION

For the reasons set forth above, we respectfully submit that the decision of the court below, denying the right of appeal to a stockholder who duly objects to a proposed settlement of a stockholder derivative action, is inconsistent with pertinent state law and practice. In order to give effect to the underlying substantive law of the state of incorporation, here Delaware, this Court should determine that the petitioners, who duly objected to a proposed settlement of a stockholder derivative action arising under and governed by Delaware law, are entitled to appeal the trial court's approval of the settlement, notwithstanding any failure to intervene as parties under Federal Rule of Civil Procedure 24.

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[19] *Kahn v. Sullivan* is thus similar to *Prezant v. DeAngelis*, 636 A.2d 915 (Del. 1994), a case noted extensively by this Court in *Matsushita Elec. Indus. Ltd. v. Epstein*, 516 U.S. 367 (1996). In *Prezant*—a class action—the objector had filed a separate action, but submitted objections to a settlement without intervening in the case in which the settlement was approved. After approval of the settlement, the objector appealed—successfully—to the Delaware Supreme Court, again without any suggestion that intervention was necessary to the appeal.

Respectfully submitted,

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